The Legal Luminary

In– house E-Newsletter of the Legal Department

Volume 3, Issue 2 | February, 2013

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NEWS

In a move that is unprecedented in modern history of the papacy, Pope Benedict (XVI) has resigned . He cited health reasons as ground for resignation

The Nigerian entertainment industry lost two popular personalities namely: Goldie Harvey, a musician and veteran actor, Justus Esiri (the Village Headmaster).

On 20th Feb, 2013, four students of the Nasarawa State University were shot dead while protesting poor water supply.

Nigeria has suspended the broadcasting licence of a radio station that repeated conspiracy theories about polio vaccines days before deadly attacks on polio clinics

From the Editor!

Welcome to another interesting edition of " The Legal Luminary". It is always a pleasure to bring you interesting articles every month. In this issue we shall be looking at a paper presented by the Board Secretary/Director, Legal Department, Barr. Alheri B. Nyako at a Workshop organized by CIBN recently, captioned 'Guarantees, Bonds & Indemnities as Contingent Liabilities'. The Q & A Section tackles the issue of financing the operations of the NDIC.

We look forward to getting your views and comments on the contents of this Edition.

Q:HOW DOES THE NDIC FINANCE ITS OPERATIONS?

A:Section 10(1) of the NDIC Act which deals with the funds of the Corporation states that "the funds of the Corporation shall consist of (a) assigned premiums paid by insured institutions in accordance with this Act; (b) income from the investments of the Corporation; (c) monies borrowed from any source with the approval of the Board and monies from any other source as may be approved by the Corporation". The NDIC finances all its overhead and administrative expenses from its investment income. The main areas for NDIC are investments in securities issued by the the Federal Government.

The assured premiums paid by insured institutions constitute the Deposit Insurance Fund (DIF) for Money Deposit Banks and the Special Insured Institutions Fund (SIIF) for Microfinance Banks and Primary Mortgage Banks

The Act provides that 'the Corporation shall have power to establish a separate Deposit Insurance Fund .

DIF) for each category of insured institution in which all assessed premiums paid shall be deposited and which fund the Corporation shall utilize for the respective insured institutions'. DIF and the SIIF are used only for paying insured deposits when an insured institution fails.

GUARANTEES, BONDS & INDEMNITIES AS CONTINGENT LIABILITIES IN BANKS

Guarantees, bonds and Indemnities are generally classified as Off-Balance Sheet (OBS) exposures in accounting parlance and regulatory perspective. This is because they constitute commitments which may not have a direct impact on the bank's assets until they crystallize. They involve transactions which are contingent in nature and therefore not recognized as assets or liabilities in the bank's balance sheet at the time the transactions are consummated.

Other OBS engagements include Bankers Acceptances, Commercial Papers, Documentary Letters of Credit, Pending Litigation, Derivatives and Underwriting Commitments.

The types of risks associated with most OBS transactions are in principle not different from those associated with on-balance sheet transactions and should, therefore, be regarded as an integral part of a bank's overall risk profile.

STATUTORY & REGULATORY REQUIREMENTS

The approaches that had been adopted over the years by lawmakers, accountants, bankers, economists and other stakeholders towards the monitoring and regulation of contingent liabilities in the banking system can be categorized into the traditional and the modern approaches as discussed hereunder:

The Traditional Approach

Under the traditional approach, emphasis is placed upon the total disclosure of all items considered – rightly or wrongly – to be contingent liabilities. Accordingly, most of the Statutes adopting this approach only require a blanket disclosure of such items in the financial statements of banks and companies. For instance, **Section 39(2)(a)(iv) of the Investment and Securities Act, 2007** requires *all* capital market operators to keep accounting records of all their assets and liabilities (including contingent liabilities).

Section 12.11(e) of the Prudential Guidelines for Deposit Money Banks in Nigeria issued by the Central Bank of Nigeria on the 1st of July, 2010 provides that contingent liabilities include:

- direct credit substitutes, e.g. general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for loans and securities), and acceptances (including endorsements with the character of acceptances)
- (certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions;
- forward assets purchases, forward deposits and partly-paid shares and securities, which represent commitments with certain draw down;
- sale and repurchase agreements and assets sales with recourse, where the credit risk remains with the bank;
- other commitments (e.g. formal standby facilities and credit lines) with an original maturity of over one year;
- similar commitments with an original maturity of up to one year, or which can be unconditionally cancelled at any time.

One major shortcoming of this approach that requires a 'blanket reporting' of contingent assets is that it gives room for ambiguities in Financial Statements and unscrupulous bankers may use such loopholes to perpetrate fraud by classifying items they do not want the auditors or regulatory authorities to discover under the head 'contingent liabilities'.

SOCIAL DIARY

We felicitate with Kashim Babagana of the litigation unit, Legal Department and his wife on the arrival of their new bundle of joy to the world on the 21st of February 2013. We pray for God's sustenance and blessing on the latest addition to the Babagana's.

The Luminary announces with pleasure the joining in holy matrimony of Mr. Nonso Okonkwo of the Legal Department and his heartthrob Chinenye Okonkwo. The ceremony will by God's grace take place on 1st of April at the basilica of the Most Holy Trinity Catholic Church, Onitsha, Anambra State. *Come One! Come All!*

The lent, one of the seven holy sacraments of the Christian religion commenced on the 13th of February, 2013.The luminary prays for God's guidance throughout this spiritual journey of perseverance.

REPLY BRIEF

Just read the articles on Financial Crimes in Nigeria. Nice one.

Besides the creation of special Financial Crimes court, I suggest we advise the Government to consider the review of both the Penal and Criminal Codes for stiffer penalties for financial crimes.

R. O. OJO

The Modern Approach: IFRS

Under this approach, the shortcomings of the traditional reporting methods of contingent liabilities were addressed. Worthy of note are the provisions of the International Financial Reporting Standards (IFRS).

Before the introduction of the IFRS, the Generally Accepted Accounting Principles (GAAP) was in operation. The GAAP refer to the standard framework of guidelines for financial accounting used in any given jurisdiction; generally known as 'accounting standards' or 'Standard accounting practice'. These include the standards, conventions, and rules that accountants follow in recording and summarizing, and in the preparation of financial statements.

The IFRS are designed as a common global language for business affairs so that company accounts are understandable and comparable across international boundaries. They are a consequence of growing international shareholding and trade and are particularly important for companies that have dealings in several countries. They are progressively replacing the many different national accounting standards. The rules are to be followed by accountants to maintain books of accounts which are comparable, understandable, reliable and relevant as per the users internal or external.

Specifically, IAS 37 prescribes the accounting and disclosure for all provisions, contingent liabilities and contingent assets, except:

· Those resulting from financial instruments that are carried at fair value;
· Those resulting from executory contracts, except where the contract is onerous;
· Those arising in insurance entities from contracts with policy holders; or
· Those covered by another standard.

The IFRS defines a contingent liability as a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. It was also defined as a present obligation that arises from past events but is not recognised because: (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or (ii) the amount of the obligation cannot be measured with sufficient reliability.

An entity should disclose a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

A contingent liability is placed in three categories, and the category it falls into gives guidance on whether it needs to be disclosed in the notes to the financial statements or not:

Probable: This category means that the future event will likely occur.

Reasonably possible: The chance of the future event happening is more than remote but less than probable.

Remote: The chance of the future event taking place is remote

Contingent liabilities and related contingent losses are recorded with a journal entry only if the contingency is both *probable* and the *amount can be estimated.* When a contingent liability is *remote* (such as a nuisance suit), then neither a journal nor a disclosure is required.

Addressing Risks Arising from Contingent Liabilities

The risks inherent in off-balance sheet transactions such as guarantees, bonds and indemnities must be recognized, monitored and controlled. Supervisors and regulators in the banking industry play a critical role in ensuring that a bank's Management does this.

Some of the risks inherent in off-balance sheet transactions include:

Credit Risk – *the possibility of loss due to default*

Interest rate risk – *the danger that fluctuations in interest rates might create losses for the bank*

Liquidity and Funding Risks – *the risk that a bank will be unable to purchase or otherwise obtain the necessary funds to meet its obligations as they fall due*

Foreign Exchange Risk – *the risk that a bank may suffer losses as a result of adverse exchange rate movements. Forward transactions, swaps, options or futures can either reduce or increase exposure to exchange rate risks.*

To limit imprudent risk taking by banks, supervisors and regulators should:

Be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all off-balance sheet risks;

Regularly obtain sufficient information to assess a bank's off-balance sheet risk exposures. Such information could be obtained through on-site examinations including spot-checks and regular discussions with players in the industry;

Ensure that generally accepted financial concepts and risk management techniques are in place;

Monitor compliance with guidelines for, and limits placed on a bank's foreign exchange/open position;

Development and utilize prudential requirement to ensure that risk are weighted and are adequately captured in their measurement of capital adequacy; and

Regularly review supervisory policies to ensure that they take full accounts of developments in off-balance sheet business.

CHALLENGES

One of the major challenges faced in the banking industry is the issue of fraudulent non-disclosure or inappropriate disclosure of guarantees, bonds and indemnities in the financial statements of banks. Many bankers over the years have fashioned ways of cleverly manipulating their records for the perpetration of fraud using the head 'contingent liabilities'.

An Expert Advisory Committee of the Institute of Charted Accountants of India (ICAI) observed that from the published accounts of many companies, "guarantee and counter-guarantee given by the Company against guarantee given by a bank on behalf of the company" were inappropriately classified under the item "contingent liabilities". The ICAI Committee was therefore of the opinion that that the correct procedure to be adopted in such case for the purpose of preparation of accounts of the Company in accordance with the requirements of the Companies Act of India, 1956 was that a contingent liability in respect of guarantees arises when a company issues guarantees to another person on behalf of a third party e.g. when it undertakes to guarantee the loan given to a subsidiary or to another company or gives a guarantee that another company will perform its contractual obligations. However, where a company undertakes to perform its own obligations, and for this purpose issues, what is called a "guarantee", the Committee was of the view that this does not represent a contingent liability and it is misleading to show such items as contingent liabilities in the Balance Sheet.

In order to address this issue, Supervisory activities have currently been extended to off-balance sheet transactions. This is because a bank that engages in off-balance sheet transactions is increasing its risk exposure. In the event that a client fails to meet up his obligations, the bank will be liable to pay the third party. Secondly, the IFRS documents relating to proper classification and disclosure (or otherwise) of contingent liabilities are couched in very technical terms that are not easily understandable by the average person. Unless the regulatory authorities are careful and diligent, many banks will manipulate their records with dire consequences for the banks, the economy and depositors in the long run.

Thirdly, guarantees, bonds and indemnities classified in the financial statement of banks as contingent liabilities present a variety of risks to a bank.

CONCLUSION/RECOMMENDATIONS

To manage the risks associated with off-balance sheet transactions such as guarantees, bonds and indemnities, the following measures should be taken by a bank:

The Board of Directors should put in place a written policy on the type and level of off-balance sheet risks a bank will undertake and should be regularly informed of the off-balance sheet risk exposures of the bank;

The Management should ensure that there is a well defined division of responsibilities between dealing, accounting and internal supervision;

The bank should identify risks inherent in new products and activities and ensure that they are subject to adequate controls before being undertaken. Major initiatives should be approved in advance by the Board or its delegated committee; It should establish and enforce operating limits and other practices that maintain exposures within levels consistent with its risk appetite;

Accounting and information systems should be adequate to capture, monitor and report all off-balance sheet exposures and related risks;

Internal controls should be regularly evaluated for adequacy and integrity;There should be an effective internal audit; The bank should also evaluate the legal structure of the countries in which it is operating, to ensure that its customers' obligations can be legally enforced;

The Management should ensure that the structure of the bank's business and the level of interest rate risk it assumes are effectively managed; that appropriate policies and procedures are established to control and limit these risks, and that resources are available for evaluating and controlling off-balance sheet risks.